Tax Bulletin of the Administrative Council of Tax Appeals

specific tax report

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Newsletter no. 37 – Year IV – April/2011

Dear Readers,

In this 37th edition of our Tax Bulletin of the Administrative Council of Tax Appeals ("CARF"), we will comment on a decision in which the CARF ruled that, in order for there to be expense deduction with premium amortization through future profitability, it is not necessary to have a positive result ascertainment in the fiscal years in which there is amortization, ruling out the application of Normative Rule of the Brazilian Securities Exchange Commission ("IN CVM") no. 247/96.

We will also analyze a decision in which the CARF decided that financial revenues earned by a legal entity in the pre-operational phase are to be recorded in the deferred charges and only taxed when exceeding financial expenses, pursuant to Normative Rule of the Federal Revenue Office no. 54/88.

Enjoy your reading.

Future Profitability Premium – Deduction – Impossibility to Condition Deductibility to the Ascertainment of Positive Results

"TAXABLE INCOME. REJECTION OF PREMIUM AMORTIZATION. EXPECTATION OF FUTURE PROFITABILITY. The tax violation is recognized to be limited to the disregard of the legal nature of the premium's economic basis, and that the financial statements filed as proof of the economic basis of the premium corresponds to asset assessment by profitability expectation. TAXABLE INCOME. REJECTION OF PREMIUM AMORTIZATION. CONDITION OF PROFIT EFFECTIVENESS. The tax laws enacted within the context of an incentive to privatizations and which remain in force in the periods subject of assessment did not condition the deductibility of the premium amortization to the effective ascertainment of profit, nor did it set a term for the generation of profits. CVM Rule no. 247/96, amended by Rule 285/98 cannot be applied for tax purposes".

The synthesis of the Appellate Decision rendered by the CARF, transcribed above, deals with an administrative proceeding arising from a Tax Assessment Notice which, among other matters, required the Corporate Income Tax ("IRPJ") and the Social Contribution on Net Income ("CSLL") related to the calendar year of 1999, as the Tax Authorities viewed that the Taxpayer had incorrectly identified the nature of the premium in its bookkeeping, later amortized, as "Future Profitability", arising from corporate takeover operations, leading to the reduction of the tax bases of the taxes in question.

In fact, two inverting companies had acquired ownership interest in the Taxpayer with premium, justifying it based on future profitability. After that, the Taxpayer took over such companies and started to take tax deductions of the expenses with premium amortization, at a monthly ratio of 1:60.

The Inspection then regarded that the amortization of expenses with premium based on future profitability is conditioned to the ascertainment of positive results in the deductibility periods, which in this case did not occur. Such position would be backed by Normative Rule of Brazilian Securities and Exchange Commission no. 247/96 ("IN CVM no. 247/96").

The Tax Authorities then concluded that the paid premium arose from "*wealth not recorded in the Balance Sheet. For such situation, the legal system validates the special rule in subitem 'c' of §2º, article 20, of DL1598/77 – goodwill, intangibles, and other economic reasons.*"

The Inspection also claimed that these are indirect legal transactions merely looking for a tax advantage, whereby the Taxpayer sought to fit into articles 7 and 8 of Law no. 9,532/97.

Dissatisfied, the Taxpayer then opposed the Tax Assessment Notice, claiming among other arguments, that the future profitability was calculated according to the "discounted cash flow" method, a common practice when assessing the value of companies.

This was demonstrated by way of documentation submitted for inspection, when the Tax Authorities came to know of some documents such as: spreadsheets for the calculation of financial projection and cash flow; vertical analysis; projection of the origin and investment of funds; reports from a renowned Consulting firm; and a report from a finance specialist, among others.

Lastly, the taxpayer claimed the impossibility of using a normative rule issued by the CVM to produce tax effects, under penalty of violating isonomy, since publicly-held companies would be subject to different taxation from those not subject to the CVM rules.

The Federal Revenue Judgment Office ("DRJ") heard the Opposition filed by the Taxpayer, but upheld the Assessment as to the rejection of expenses with premium amortization.

Against this decision, the Taxpayer then brought a Voluntary Appeal with the CARF, based on the same arguments presented to the DRJ, besides stating that the DRJ applied a reason that had not been presented by the Inspection, such

as the fact of not having ownership interest in the acquired companies.

After granting the Voluntary Appeal, the Councilors considered that the acquired companies had been set up without a business purpose, and were only a vehicle for the premium. However, they decided that, in fact, that the Inspection had not disregarded the occurrence of the transactions, so there was not point in doing so now.

They observed then that the basis of the assessment lay exclusively on the rejection of the premium's nature attributed to the Taxpayer. In this regard, the Councilors claimed that the tax laws do not condition the deductibility of expenses with the amortization of premium by future profitability to the effective ascertainment of positive results, and that IN CVM no. 247/96 does not apply to tax purposes.

The Councilors also established that the Inspection failed to inform the calculations and reports that substantiated the record of the premium, such documents which therefore must be accepted. Due to this, they granted the Voluntary Appeal in order to cancel the assessment as to the rejection in question.

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Financial Revenues in Pre-Operational Phase – Accounting Record in the Deferred Charges and Matching with Financial Expenses - Possibility

"FINANCIAL REVENUES. PRE-OPERATIONAL PHASE TAX TREATMENT. Pursuant to the accrual principle, the financial revenues earned in the pre-operational phase are to constitute a subtraction element of the incurred pre-operational expenses, thus taxation only applies in the situation in which the total revenues exceed the amount of these pre-operational expenses. The repeal of IN SRF no. 54, of 1988, which provided for such, is not an impediment to the tax treatment at issue, as it cannot be accepted that the mechanisms and principles it established were also eliminated from the legal system ."

The decision synthesis in question concerns the Appellate Decision rendered by the CARF, under administrative analysis, arising from a Tax Assessment Notice issued for the collection of the IRPJ and CSLL related to the ascertainment periods from 2001 to 2003.

The Treasury Authorities verified in a tax audit, mainly through the matching of information between the DIPJ (Corporate Economic and Tax Information Statement) filed the Taxpayer and the DIRF (Withholding Income Tax Statement) filed by the paying source (financial institution), that in the periods in question the Taxpayer had omitted earnings from financial investments.

In disagreement with the Assessment issued against it, the Taxpayer then opposed it, claiming, among other things, that part of the amounts required by the

Inspection, related to the financial revenues, could not have been taxed, taking into account that they were revenues earned in a "pre-operational" phase, for which reason such amounts should be recorded in the deferred charges and also matched with the financial expenses, and only taxed to the extent they exceed the expenses, as recommended by Normative Rule of the Federal Revenue Office Federal no. 54/88 ("IN SRF no. 54/88").

In examining the filed Opposition, the DRJ considered that the reasons alleged by the Taxpayer were groundless, which then led to the latter filing a Voluntary Appeal with the CARF reiterating the arguments exposed above.

Thereafter, the former 1st Taxpayers' Council converted the judgment into an inspection, resulting in a Tax Report which corroborated the assessment.

In hearing the case once more, the assigned Reporting Councilor granted it specifically as to the discussion of the pre-operational financial revenues, so as to rule out such tax requirement.

The Reporting Councilor considered that the procedure adopted by the Taxpayer, when recording the revenues earned in the pre-operational phase in the deferred charges, is correct and in accordance with the pertinent legislation. The reason is that although IN SRF no. 54/88 had been repealed, the normative rule in question set procedures based on commercial and tax laws, which set forth the mechanisms and principles that remain valid.

Furthermore, the Councilor transcribed Divergence Solution no. 32/08 to the vote, which deals with the matter under discussion and concludes likewise, that is, that the pre-operational financial revenues and expenses are to be recorded in the deferred charges, and that there should be taxation only on the amount of revenues exceeding the expenses.

Therefore, based on the fact that "*a) Appellant had incurred pre-operational in excess of the financial results recorded in the deferred charges; and b) that the mentioned financial results, considering the legislation in force at the time of the facts, derived from funds that contributed to the formation of the result of more than one fiscal year*", the CARF then granted the Voluntary Appeal brought by the Taxpayer in order to rule out the requirement in this regard.

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